CAPITAL ECONOMICS

Talks end without deal; US announces naval blockade

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The breakdown in talks between the US and Iran does not necessarily signal the end of efforts to resolve the conflict but the introduction of a US naval blockade on Iranian shipments transiting the Strait does introduce a new potential flashpoint. From a macro and markets perspective, this nudges us closer to the outcomes in our "adverse scenario".

The collapse in negotiations is not especially surprising given the gap between the two sides. We flagged at the time of last week's ceasefire that any durable agreement would require significant concessions from both parties. The key sticking points appear to surround Iran's continuing control over uranium stockpiles, its pursuit of nuclear capabilities, its funding of regional proxies, and its effective control over shipments through the Strait of Hormuz.

President Trump has responded by announcing a naval blockade against ships entering or departing Iranian ports. The blockade is due to commence at 10am ET today. This will cause slight additional tightening in global oil markets, which is reflected in the ~7% increase in Brent crude prices to over $100pb in Asian trading. Iran accounts for roughly 4% of world supply, much of which is exported to China. By blocking Iran's principal source of foreign currency inflows – Iran's oil exports were equal to ~$45bn last year, or 13% of GDP – the move will exacerbate balance of payments strains and compound the damage to Iran's economy from the war.

The move is clearly intended to increase pressure on Tehran but it may also be designed to pressure Beijing into playing a more active role in mediating a ceasefire and reopening full trade flows through the Strait. In practice, however, it risks creating new potential flashpoints. Would the US Navy seize allied ships that have paid tolls to Tehran? Would it target Chinese vessels in the Strait? Either outcome would represent a significant escalation.

Beyond this, three things are worth watching over the coming 24 hours. The first is whether the broader ceasefire in the region continues to hold – for now, it appears to be doing so. The second is whether there are renewed efforts by third parties to bring the US and Iran back to the negotiating table, and how both sides respond. And the third is how Iran reacts to the blockade – in particular, whether it seeks to disrupt oil shipments elsewhere in the Gulf, for example via proxy attacks on shipping in the Red Sea. So far, exports via its west coast port of Yanbu have been key for Saudi Arabia in diverting its oil flows away from the Strait of Hormuz.

Developments over the weekend reinforce a broader point we have made before: while both sides may ultimately want a deal, their positions reflect deeper and, in Iran's case, existential concerns. The longer the conflict drags on, the harder it will be to find common ground on which an agreement can be reached.

The reaction in markets has followed the familiar playbook seen during recent escalations – a stronger dollar, weaker equities, and, despite a general rise in risk aversion, higher bond yields as markets price in the inflationary consequences of elevated energy prices and further disruption to supply. The moves in markets have so far been fairly small compared with the earlier escalations. Nonetheless, all of this pushes us closer to the “adverse scenario” that we outlined in our recent forecasting round which would include a drop in global growth into recessionary territory and widespread interest rate hikes. Whether we get there will depend on how events unfold over the coming week.